

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 96-0196 and 02-0001
Corporate Income Tax
For the Years 1991 – 1993 and 1997

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ISSUE

I. Corporate Income Tax—Computation of NOL

Authority: IC 6-3-2-2.6; IC 6-3-2-12.

Taxpayer protests the Department's computation of Taxpayer's net operating loss. The issue is if the foreign source dividends are deducted in determining the NOL.

II. Corporate Income Tax—Flow through of income reported in K-1s

Authority: 45 IAC 1-1-159.1; IRC § 704.

Taxpayer argues that interest income, capital gains, and other income reported on K-1s is not flow through income; on this basis, it should not be subject to gross income tax.

III. Corporate Income Tax—Industrial Processing Service Income

Authority: IC 6-2.1-5-5(d).

Taxpayer argues that the income that the Department taxed as industrial processing service income is incorrect. Taxpayer argues that title passed from their customer to them and then back to the customers—making it sales in interstate commerce. Additionally, taxpayer argues that regardless if it is industrial processing or not, the income is not taxable because it is income included in the consolidated return. The Department verified that this is true for 1993 and it to be removed as an intercompany elimination. However, the issue is to be decided for 1991 and 1992.

IV. Corporate Income Tax—Forgiveness of Debt

Authority: 45 IAC 1-1-10.

Taxpayer argues that forgiveness of debt taxed for gross income should not be taxed because there was a mortgage on the property.

V. Corporate Income Tax—Penalty

Authority: IC 6-8.1-10-2.1(a)(3); IC 6-8.1-10-2.1(b); 45 IAC 15-11-2(b);
45 IAC 15-11-2(c).

Taxpayer objected to the imposition of a 10% penalty on the deficiency assessed.

Resolved Issues

These issues are resolved. They are included in this letter of findings so as to have a record that all outstanding issues for the periods in question have been addressed and resolved.

- **Protest Issues I. and II.—T Ave Co.**

The Department has removed adjustments to Taxpayer's consolidated return relating to T Ave Co. in the existing audits and will refrain from taxing the income of that company through the end of the 2001 tax year. The Department will revisit the issue for all subsequent years.

- **Protest Issues VI. And VII.—B Management**

The Department has verified that the income from the sale of tangible personal property is low rate income. This makes the double taxation protest moot.

- **Protest Issue VIII.—Specific commission income**

The Department has verified and has adjusted the assessment.

- **Protest Issues IX and X—Royalty income**

The Department has verified that the royalty income was properly deducted as intercompany transfers.

STATEMENT OF FACTS

Taxpayer is a multi-tiered organization with subsidiaries and affiliates engaged in two distinct lines of business: a multi-state chemical manufacturing & refining business and an investment real estate partnership.

I. Corporate Income Tax—Computation of NOL

DISCUSSION

Taxpayer protested the computation of the net operating loss deduction, claiming that the computation of loss should include the foreign source dividend deduction. The NOL deduction is calculated using the guidelines in IC 6-3-2-2.6. The foreign source dividend deduction is allowed under IC 6-3-2-12. Foreign source dividend is not included as a deduction in the NOL calculation outlined in IC 6-3-2-2.6. The foreign source dividend deduction is only allowed in computing the current year adjusted gross income and is not allowable when determining the NOL deduction. This issue was addressed and denied in a previous letter of finding issued concerning Taxpayer.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

II. Corporate Income Tax—Flow through of income reported in K-1s

DISCUSSION

Taxpayer objected to the Department's computation of gross income attributable to its distributive shares of partnership income. Taxpayer argues that certain distributive share income items reported on their K-1s should not flow through as taxable gross income. Specifically, Taxpayer objects to the flow through of interest income, capital gain income, and other income. In addition, Taxpayer argues that there is no basis to disallow certain negative flow through items within the separate K-1 items. Taxpayer argues that the only item of flow through should be ordinary income.

45 IAC 1-1-159.1, which was the regulation in force for the audit years in question, states that an amount credited to a corporate partner as its distributive share of partnership income which is derived from sources within Indiana is subject to gross income tax—provided the partnership has not previously paid the gross income tax due. The Department has held, based on the regulation, that net distributive share income is subject to gross income tax. Taxpayer argues that since sections of the regulation only incorporate part of IRC § 704, interest, capital gains, and other income are not part of the flow through income of the partnership distribution. There is no basis to hold that these items are not part of flow through income.

As well, the Department disallowed the negative income items within a particular K-1 from being netted against positive income items to determine the net distributive share. The department determined that this calculation was not appropriate for this K-1 and disallowed the net calculation, leaving the positive distribution for this K-1 as flow through income subject to gross income tax. Taxpayer has failed to adequately rebut the Department's position.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

III. Corporate Income Tax—Industrial Processing Service Income

DISCUSSION

Chemicals were transferred from Taxpayer's chemical subsidiary to Taxpayer's industrial subsidiary. The Department asserted that Taxpayer was acting as an industrial processor. Taxpayer argued that title passed from chemical subsidiary to industrial subsidiary and then back to chemical subsidiary. Taxpayer argued that these receipts are exempt because they are derived in interstate commerce. Taxpayer stated in its protest letter that it objects to the classification of the sale of tangible personal property as an industrial processing service performed in Indiana

and subject to Indiana gross income tax. This issue was addressed and denied in a previous letter of finding issued concerning Taxpayer.

In this protest, Taxpayer included an additional argument to their protest—that the income was an intercompany transfer. For tax year 1993, Taxpayer is correct because a consolidated return was filed and the income was eliminated as intercompany. IC 6-2.1-5-5(d) statutorily permitted affiliated corporations to file consolidated returns. This had the accounting effect of eliminating as income receipts transferred between affiliates. But for 1991 and 1992, Taxpayer did not file a consolidated return; therefore, an intercompany elimination of income cannot be performed.

FINDING

For the reasons stated above, Taxpayer is sustained for 1993 and is denied for 1991 and 1992.

IV. Corporate Income Tax—Forgiveness of Debt

DISCUSSION

Taxpayer objects to the Department imposing gross income tax on the conveyance of title to real estate in lieu of foreclosure. Taxpayer argues that forgiveness of debt should not be taxable as there was a mortgage on the property.

This is a constructive receipt of income. Taxpayer owned a piece of property which had a mortgage on it; the mortgage exceeded Taxpayer's cost. When the property was foreclosed, the mortgage was written off. Thus, Taxpayer has a gain for forgiveness of debt in excess of their cost. This is taxable under the guidelines of 45 IAC 1-1-10, which states that constructive receipts are those items of gross income which are not actually received by the taxpayer but which are credited to the taxpayer; constructive receipts include the partial or complete forgiveness of debts; such receipts are required to be reported on the tax return for the tax period in which they are credited.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

V. Corporate Income Tax—Penalty

DISCUSSION

Taxpayer objected to the imposition of a 10% penalty on the deficiency assessed. In the letter of protest submitted to the Department, Taxpayer states, "Due to the fact that the audit of taxable years 1988, 1989, and 1990 was not completed until February 23, 1995, many of the issues related to the audit adjustments for taxable years 1991, 1992, and 1993 were unresolved when the taxpayer prepared its Indiana returns."

According to Department records, the original audit report for 1988 – 1990 was completed on October 19, 1992. The supplemental audit report was completed on February 23, 1995.

IC 6-8.1-10-2.1(a)(3) states that if a person is examined by the Department and incurs a deficiency that is due to negligence, the person is subject to a penalty. In general, the penalty is 10%. *See* IC 6-8.1-10-2.1(b). 45 IAC 15-11-2(b), states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and thus was subject to a penalty under IC 6-8.1-10-2.1(a). Taxpayer has not established that its failure to pay the deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

For the reasons stated above, Taxpayer's protest is denied.